MEMORANDUM FOR: Director of Central Intelligence

FROM: Maurice Ernst
NIO for Economics

This is a well conceived speech you may be interested in looking at.

Maurice Ernst

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Department of the Treasury
Special Assistant to the Secretary for National Security

to: Maurice Ernst
NIO/Economics
room: date: 19 Mar

Maurice,

Thought you might be ~~interested~~ in the attached.

Doug

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MC INALLY LECTURE
UNIVERSITY OF MICHIGAN BUSINESS SCHOOL

THE HONORABLE R. T. MC NAMAR
DEPUTY SECRETARY OF THE TREASURY
ANN ARBOR, MICHIGAN

November 15, 1982

The Inexorable Linkage: International Trade and Finance

The United States is about to join 87 other nations in Geneva in what has been billed as the meeting of the decade to determine the framework, direction, and momentum for international trade relations for the indefinite future. The GATT Ministerial on November 24-26 may, indeed, give both observers and government policymakers a clearer indication of whether nations will go-it-alone in international trade or make the difficult individual political decisions necessary to work together to deal with the serious trade and financial problems that now threaten the international economic, financial, and political systems that have served the Free World for the last three and a half decades.

The very real danger is that individual governments will choose the course of economic isolationism on the basis that their own "domestic" economic situation makes it politically impossible to make any major new commitments to the open trading system -- or even to uphold present ones fully. The GATT Ministerial decision may well set the tone of international economics, and therefore international political relations generally for the rest of the 20th Century.

R-1027

Today the world watches the United States, Japan, and the European Community to see whether they will assume or abdicate their role as world economic leaders. Each is vulnerable to abdication. Each has opportunities to lead. The U.S. faces intense domestic political pressures to avoid adjustment to new economic realities and loss of comparative advantage in some established industries. This has led to calls for other nations to further subsidize their industries. Japan is threatened with exclusion from its U.S. and EC markets unless it assumes the full measure of international economic responsibility and liberalizes its policies on imports. And, with record unemployment rates in the EC, coupled with recent political polarization, there is a distinct possibility that the EC will continue its pro-protectionist trends, turn its back on the developing nations of the world in its futile search for domestically politically popular, economically short-sighted policies. Indeed, it is fair to ask whether Western liberal democracies can maintain both an open market and free trade consumer welfare policies in the face of today's challenges.

To be sure, the current international economic environment is one of the most difficult national leaders have experienced in some time -- certainly the most politically difficult trade situation since the 1930s, when strong protectionist pressures were coupled with poor economic growth and high unemployment.

In a recent op-ed article in the Washington Post, Sir Roy Denman noted that world trade declined by 60 percent during the trade debacle of the 1930s. Are we doomed to repeat those mistakes? Have the American people just elected a Congress that will revisit the beggar-thy-neighbor trade measures of that era? Or can we resist pressures for these kinds of trade actions and avoid the collapse of the international financial system?

I think we can -- which may make me the only optimist about free trade in the room. But I recognize that the United States cannot do it alone. Our economy is too closely linked with those of other nations to turn away from the problems of other nations, or to deny the effect of our economic policies on others. The period ahead is not going to be easy. It will require strong world leadership to maintain an even keel and a pragmatic approach. We are going to have to judge very carefully what policies are in the best interest of the U.S. economy as a whole before jettisoning our traditional open market approach and joining the foreign trend toward active government intervention to further restrict international or domestic markets.

That's a mouthful. But it reflects my own deep conviction that our trade, financial, and domestic economic policies are today so integrally related that we have no other choice. We cannot look at each of them in isolation, attempting to deal with trade issues apart from their implications for the international economic situation or for the future strength of the U.S. domestic economy. More than ever before, each nation, in its policy deliberations, must recognize and take into account the close inexorable linkages that are ever tighter between these policy areas. Only by recognizing the interrelationships can we synthesize an overall policy approach, and avoid inherent policy contradictions.

That's the conclusion of all the remarks I will make today. And while I know the University of Michigan Business School doesn't use the case method for teaching; case studies, however, were an acceptable method of learning within the University of Michigan Law School, which I attended, and they continue to be used at some perhaps less progressive business schools further East. So, with due apologies to the Business School, what I'd like to do today is offer an analysis of the current international economic situation as the backdrop for a case study of government policymaking in the international economic sphere. I'll attempt to provide an overview of recent economic facts, describe a mythical foreign industrial country, and let you choose the policies which this country should now pursue.

But I'm getting ahead of myself. I'd like to structure the case analysis -- and betray a few of my own convictions as I do so -- by focussing on four major themes:

1. International integration now makes isolationism in trade -- or other economic policies -- virtually infeasible, and totally unacceptable as a policy prescription. Indeed, for the industrial democracies the distinction between domestic and international economic policy is now largely obsolete.

2. The collective response to the developing countries' debt problems will be crucial to the future of the international financial system, and the actions we take in the trade area should in no way jeopardize this situation. The less developed nations must be able to import the equipment and energy needed goods to continue their domestic economic growth. This will require net new financing, and preserving their export markets in the industrialized countries. All are necessary to preserve the economic gains necessary to underpin the Free World's political stability.

3. Most nations still have not fully adjusted to the consequences of the overly expansive economic policies they adopted to ease the "oil shocks" of the 1970s; yet now they also have to face a new "disinflation shock". In an attempt to wring out the old problem of high inflation from the economy, governments have been forced for the near-term to accept low real economic growth. Reducing world trade will only compound the economic problems for nations dependent upon export-led recovery.

4. Trade measures adopted because of the transient political imperative of the moment only defer the inevitable economic adjustment. Protectionist measures only deal with the symptoms of problems -- import penetration, weak exports, loss of comparative advantage -- not their underlying causes. More to the point, all industrial and developing nations cannot simultaneously restrict imports and increase exports. Each nation's export is some other nation's import.

My conclusions stated, let me attempt to persuade you of their validity.

International Integration: The Importance of Trade

Stimulated by the substantial reduction of tariffs among industrial countries during the Kennedy Round of trade negotiations in the 1960s, as well as by strong and continuing domestic economic growth, international trade became the most dynamic part of the global economy. In the decade of the 1970s, the strong growth in international trade and an extraordinary increase in the use of private international financing provided to developing countries fostered their economic growth.

World trade increased eleven percent annually during the period 1970-73, and although it grew at a slower pace after the first oil shock, it still averaged six percent annual growth for the decade as a whole -- considerably faster than the growth in world gross national product. Relatively low levels of unemployment and the boom in global demand for both capital and consumer goods encouraged nations to provide increasingly open markets for international goods -- until the first oil shock in 1973 and the subsequent pressures for trade restrictions that developed during the recession of 1974-75.

In the aftermath of that recession, trade again picked up, although at a slower pace, as the major industrial nations adopted expansionary fiscal and monetary policies. While contributing to the subsequent increases in inflation, these inflationary policies did give a boost to trade, as did the continuing strong economic growth of most LDCs, and newly industrializing countries like Korea and Mexico.

For the United States, exports in the latter part of the last decade actually grew twice as fast as the growth of world trade. U.S. exports as a share of GNP doubled between 1970 and 1979. By the end of the decade, exports accounted for one out of three acres of U.S. agricultural production, one out of eight U.S. manufacturing jobs, and nearly 20 percent of U.S. production of all goods. As world trade expanded, other countries also became more dependent on both imports and exports to earn the foreign exchange to pay for their increasing imports.

Rising inflation and the oil shocks of the 1970s also spurred an enormous expansion of international capital flows and greater interdependence among financial institutions and financial markets. International banks in the United States and abroad have provided the bulk of financing required to support economic growth and burgeoning trade flows between developed and developing countries.

Financial transactions have now become so interrelated that we have, in effect, one worldwide market for a wide spectrum of borrowing, lending, and investment activities. Offshore banking centers and telecommunications link New York, London, Frankfurt, Bahrain and Singapore so that the sun never sets on the world's continuous banking activity. Banks serve customers throughout the world and have the capacity to attract or borrow deposit funds in one center and to place them with borrowers anywhere in the world. Although the sources of funding may change, the role of the private financial intermediary remains the same. Thus, the dropoff in OPEC surplus and net withdrawal of OPEC funds from banks in the international banking market has been compensated by increases in the share of funding from other principal sources, i.e., the developed country centers, particularly the United States.

The implications of this heightened interdependence are profound. We can now communicate instantaneously to all parts of the world and move billions of dollars electronically in minutes in response to a variety of complex market factors. Total transactions in the U.S. foreign exchange market are often in excess of $100 billion per day.

Interdependence for all Nations

Against this web of financial ties, consider individual nations' economic policies. Substantial divergences in economic performance among the major nations can have a significant impact on the stability of the system as a whole. Economic stagnation in the industrial world is soon transmitted through declining demand for imports to reduced exports for the developing nations, which are dependent on exports to maintain and help finance the economic growth and development of their domestic economies. The interrelationship is simple: if the developing nations cannot export; they cannot import capital goods to transform the developing countries from being an exporter of commodities to being an exporter of finished products where they enjoy a comparative advantage. If they can't export, they can't pay their debts to the commercial banks of the developed countries that want to export to them. Again, there is a clear linkage.

And finally, particularly with fixed exchange rates, the efficacy of policy measures adopted by any individual nation is more limited than ever and more subject to the influence of the global economy. Today's flexible exchange rate system reduces the ability of governments to influence capital investment and savings through domestic actions, because of the ultimate exchange rate effects.

To further illustrate the tie between domestic and international policies, the sizeable foreign exposure in developing countries of U.S. and other nations' commercial banks and their interbank borrowing must be considered along with their primary anti-inflationary objectives by central bank monetary authorities when they establish domestic monetary targets. Thus, even the Federal Reserve cannot be truly "independent" in its policymaking. It operates in an international not isolated domestic market.

As Canadian Prime Minister Trudeau stated in September at the annual meeting of the International Monetary Fund and the World Bank in Toronto, "our economic interdependence compels us to understand that since many of our problems transcend international borders, we must solve them together if they are to be solved at all." His words contain a warning against individual actions by nations. His insight is that not only is "no man an island", but no nation any longer can be insular. Let's examine further how this came about.

Legacy of the Oil Shocks

The relatively bright trade picture of the early 1970s has now changed substantially. In major part this is due to the failure of the world economy as a whole to adjust adequately to the dual oil shocks of 1974-75 and 1979-80. The cost of oil rose over 1,000 percent between 1973 and 1981 -- from approximately $3 per barrel to over $34 per barrel.

However, these data only tell the story for the United States. Since oil trade is almost exclusively priced in U.S. dollars, to look at the oil shocks in terms of other countries, we should look at these oil price increases in local currencies. That is, how many DM or yen did it take to buy the dollars necessary to buy the oil at ever-increasing prices? I'll examine two periods: (1) the full decade, 1972-1982 and (2) the most recent period of strength in the U.S. dollar, 1979-1982.

For the full decade, the cost of oil in three major currencies -- dollars, yen, and deutschmarks -- increased by approximately the same percentages: 1,034 percent, 1,046 percent, and 998 percent, respectively -- all about 10-fold increases. However, for Belgians using Belgian francs, the increase in the price of oil for the decade was further aggravated by the relative appreciation of the dollar (and decline of the Belgian franc against the dollar, yen, and DM) during this period. Thus, for two key industrial countries, Japan and Germany, the increase in the cost of oil imports was relatively the same as for the United States for the decade, but for others, including many LDCs, the cost of the oil shocks was far more.

Turning to the more recent period, 1979-1980, differences in the cost of oil imports due to the value of the dollar for individual nations are more distinct and more drastic. The increase in dollar terms was 174 percent, 219 percent in yen, 246 percent in deutschmarks, and 299 percent in Belgian francs. This shorter timeframe has been used by some as evidence that the appreciation of the dollar since 1980 has had an effect on certain economies similar in nature -- if not in extent -- to the second "oil shock" itself, but has only affected countries outside of the United States.

National leaders who look exclusively at this more recent time period may want to argue that this third shock -- "the dollar oil shock" -- has hit them as a double-whammy: boosting the cost of oil imports and exacerbating overall trade/current account imbalances. The only ameliorating effect is that it has also boosted the U.S. demand for their goods, by decreasing the relative cost of their exports in dollar terms. This boost to other nations' exports has been felt in the United States in terms of increased import competition, as in steel in the last two years.

To be balanced, I should also point out that the decline in some currencies relative to the dollar has reflected in large part a market reaction to the domestic economic policies in these countries. Continuing high inflation and rising budget deficits relative to other countries, for example, has contributed to the depreciation of some European currencies. Many commentators suggest the current weakness of the yen is also attributable to deteriorating budgetary and export prospects for Japan.

Without going off on too much of a tangent, I would like to make two general observations from these basic facts:

1. Unfortunately, politicans always look at a shorter time horizon than economists. There's little political future in good economic policies. Indeed, in a free society, too often good economic policies and good politics are anathetical.

2. Exchange rates do affect trade flows, but they affect them in both directions. If the changes aren't overly speculative and destabilizing to the system as a whole, over time they should always balance out through trade and exchange rate adjustment.

One additional factor should also be mentioned with regard to the oil shocks. The percentage increase figures don't reflect the efforts of a number of nations to reduce the volume of oil imports over this period -- or the relative increase in oil import volumes for others. Nor does it say anything about the ability of nations to pay the higher import bills. I suggest a more analytically comprehensive figure is the percentage of exports needed to pay for oil imports over a time period: this figure helps to demonstrate the cost of oil imports in terms of a nation's trade account as a whole.

For the period 1972-1981, the share of exports needed to pay for oil imports increased substantially for all nations -- but more for some than for others. For Japan the share more than doubled. In 1972, 14 percent of Japanese exports were needed to pay for oil imports. In 1981, 35 percent of Japanese exports went for this purpose. Had Japanese exports stayed at their 1972 level, all of these exports would have gone to pay for oil imports -- and still would not have met Japan's full oil import needs. Obviously, there would have been no foreign exchange to buy other essential imports, such as coal, grain, or lumber from the U.S. These facts help to demonstrate Japan's heightened need to export more manufactured goods -- such as cars and TVs where Japan has a comparative advantage in order to pay for its oil imports needed to keep its people warm and employed. Japanese Diet members, like their peers in the other industrial democracies, follow the same logic as do U.S. Senators and Chamber of Deputies members.

Similarly for Belgium and Brazil, the share of exports needed to pay for oil imports tripled during this period. In 1972, Brazil needed 14 percent of its export earnings to pay for oil. Today, half of Brazil's exports now go simply to pay for its oil imports. For the United States, the comparable increase was from 5 to 28 percent. The sharp increase in U.S. agricultural exports, where we enjoy a comparative advantage, has helped the U.S. pay for our ever more costly oil imports.

In sum, the dramatic oil price increase and dollar oil price increases produced two major economic consequences worldwide:

1. As compared to the 1960s, the rate of inflation nearly tripled for both developed and developing countries. The average inflation rate for OECD nations in the 1970s was 8.4 percent; for LDCs, 26.5 percent. Much of this increase was due to the oil price shock, but expansionary monetary and fiscal policies in a number of countries were also a major contributing factor. In addition, in European countries the use of wage indexation schemes further ratcheted up inflation rates. Indeed, indexed domestic social programs costs in industrialized countries increased as a result of external or international inflationary shocks: oil price increases and foreign exchange movements. Again, I suggest the interwoven fabric of international and domestic policies interacts in often unforeseen ways.

2. During the decade, non-OPEC trade and current account balances plummeted. OECD surpluses were transformed into an average deficit of $14 billion in 1974-80, while the small LDC deficit jumped to an average of $40 billion. Lacking economic adjustment, these deficits had to somehow be financed. Indeed, they were by the international commercial banks.

LDC Debt: The Need to Adjust

There has been a great deal of analysis and discussion about the need for structural adjustment to the new oil price situation. Unfortunately, too little adjustment has actually taken place. Usually, as in the United States, the political process has impeded the necessary economic changes.

However, economic adjustment is especially critical for the LDCs whose external debt has ballooned in recent years. Let me explain. With few exceptions, developing countries have increased their international debt rather than adopt the domestic measures needed to adjust structurally to the higher cost of oil and inflation of the 1970s. That is, they failed to bring about a sustained reduction in their merchandise and current account deficits in order to reduce the need to borrow. LDCs have too often preferred to rapidly increase imports for consumption to maintain or increase current living standards and at the same time increased imports capital goods for industrial development. Increasingly these imports were financed in larger and larger proportion with borrowed funds for the commercial banks. Thus, rather than utilizing increased foreign exchange earnings from exports with sustainable external debt increases from economic development, too many LDCs attempt simultaneously to: (1) build an industrial economy; (2) increase consumption; and, (3) count on higher and higher inflation to cover their current policy excesses. As a result, LDC debt has grown at a rapid but unsustainable pace. The recent scale of LDC borrowing to finance imports in order to achieve rapid economic development was unprecedented.

Net new borrowing by the non-OPEC LDCs from banks in the major industrialized countries jumped from $10.5 billion in 1977 to $22 billion a year later in 1978 and almost doubled again to $41.6 billion in 1981. The outstanding balance of debt owed to private Western banks by these countries, primarily in Latin America, reached $230 billion by the end of 1981, and exceeds a quarter of a trillion dollars today.

However, at the same time, a concurrent trend was developing that would ultimately undermine this continued growth in LDC borrowing. Inflation expectations and performance had begun to change. Industrial countries generally had shifted away from more expansionary domestic policies toward policies of disinflation. For the developing countries in particular, this has introduced a new "disinflation shock" or transition to lower nominal increases in economic growth.

As a result, commercial lenders and finance ministries of borrowing nations are re-evaluating loan portfolios that were established under quite different expectations about future inflation. Levels of debt which seemed sustainable under assumptions of continuing ever-increasing inflation and therefore growing export receipts, suddenly are very high in real terms after accounting for inflation. And new borrowing is necessarily more costly in real terms, since borrowers can no longer expect to repay loans with ever cheaper dollars as happened in the latter part of the 1970s. Today, real interest rates are higher and the dollar exchange rate has become more costly from an export earnings standpoint.

As a result, fundamental economic adjustment measures are needed to deal with this situation. Overall LDC cashflow requirements for financing must be reduced. In the very short run, this can only be accomplished by a reduction in LDC imports, either by reducing aggregate demand (and hence GNP growth) or by direct restrictions on imports. Over the longer term, export expansion and import substitution must become part of the more fundamental structural adjustment by non-oil LDCs. New domestic investments and expanded export production capacity, however, will only occur after a considerable time lag. At the same time, rescheduling and restructuring of external debt maturities is essential to better match export earning and cashflow potential.

For their part, bankers in industrial nations will tend to be increasingly selective in additional new lending. But it is crucial that new lending not be imprudently curtailed by all lenders. Banks will also look to international financial institutions, particularly the International Monetary Fund, for support operations, additional medium-term funds, and the imposition of programs requiring greater economic policy discipline in those LDCs whose debt positions are least sustainable.

To understand the plight of the LDCs, we must comprehend the magnitude of their problems. A general decline in key commodity prices has exacerbated the problem for LDCs and reduced their total export earnings. World sugar prices have dropped 65 percent since 1981, causing the United States to impose import quotas to protect domestic price supports for sugar and further reducing export earnings for the major sugar exporting countries. (Again note the linkage of international and domestic policy considerations.)

Wheat prices have fallen 14 percent over this same period, with a major effect on Argentina's exports. Copper prices have fallen 34 percent since 1980, affecting Peru's exports, among others. For nations that rely mainly on commodity exports for foreign exchange earnings, the combination of a worldwide recession and the transition to disinflation has been brutal in terms of deteriorating current account balance.

The Future

What do the current debt problems of LDCs mean for international trade, and for employment and growth prospects in the developed countries? They require, in essence, that industrial nations face a reversal of the export-led growth phenomenon of the 1970s. LDC reductions in imports -- and the future expansion of LDC exports -- are crucial to the stability of the international financial system. In a slow-growth world, however, this means that developed countries will have to accept the reverse swing in LDC trade to enable adjustment to occur.

Industrial nations' exports to LDCs may decline in real terms, yet industrial nations must continue to keep their markets open both to other developed countries and to LDCs to keep the international trade and financial systems from dissolving. Protectionist moves among the industrial countries will merely compound the problem -- already of sufficient magnitude -- by reducing the developing countries' ability to repay their debts, diminishing trade as an engine for economic growth, and possibly precipitating a global financial crisis. An implosion of trade and new financial credits would be shortsighted, self-defeating, and politically hazardous to the stability of the Free World.

For OECD nations which are now enduring a major recession and near-record unemployment levels, this prospect is not encouraging. After-inflation OECD economic growth has averaged less than one percent during the last three years, while the volume of world trade has actually declined for the first time since the 1940s. Serious overcapacity in major industries such as steel, autos, and shipbuilding has created strong protectionist pressures -- and further increases in imports from LDCs will be met with a jaundiced eye within these industries in particular.

How harshly will the necessary LDC adjustment affect the industrial countries? For analytical purposes let's assume an extreme hypothesis: that commercial banks extend no net new loans to LDCs. This would suggest a reduction of \$45 billion in new financing -- roughly 15 percent of LDC imports. Such a cutback would reduce OECD growth rates up to 1 percent. About \$10 billion of this decline would come in U.S. exports, with a lesser effect on U.S. GNP since trade is still less important to the U.S. economy than to other OECD nations. In Europe, there would be no trade led recovery from the current recession and unemployment would sharply increase and cause further political instability. In Japan, the OPEC oil bill simply could not be paid without dramatic and politically unpalatable changes.

Can the international economic system meet this challenge? Indeed, can the current international system as we know it survive? These are the questions I ask you to answer.

Before I pass this policy dilemma to you for your consideration, I would like to make a few general comments regarding the policy considerations that I personally find of critical importance to the future:

1. The importance of the developing nations to the U.S. economy and to the global economy is usually overlooked or misunderstood. Non-OPEC LDCs now account for nearly 30 percent of U.S. exports. That is more than the European Community and Japan combined. Non-OPEC LDCs supply 25 percent of U.S. imports. LDC exports represent 17 percent of world trade, and their imports are nearly one-fourth of global imports. Their economic health is critical to the world economy. And, I submit, the United States' own foreign policy and economic future increasingly depends on their economic progress.

2. The crucial issue for industrial nations will be creating a climate conducive to LDC economic adaptation and adjustment. This means not impeding LDC export growth, accepting cutbacks in LDC imports where necessitated by a stringent balance of payments and debt situation, and working within the international financial institutions to encourage better discipline on future LDC economic behavior.

3. All the multilateral financial institutions must play a key role in the adjustment process. The International Monetary Fund must play a pivotal role in fostering timely and smooth adjustment by the LDCs. Current IMF policy recommendations aim at reducing government interference in domestic economies, reducing subsidies and budget deficits, eliminating price controls and inefficient industrial support, and establishing realistic exchange rates and relative prices. These policies should be continued, and the IMF should maintain strong conditionality of its loan programs to insure that such changes do in fact occur. Indeed, to provide added incentives for adherence to IMF backed policies, disbursement of net new commercial loans might be more closely tied to meeting IMF program standards.

4. Each individual LDC must take the politically unpopular decisions to eliminate subsidies they have used to shield their people from the ravages of the world's oil shocks. Whether it is artificially low interest rates, export subsidies, controlled gasoline or bread prices, they must be adjusted to better reflect world market prices. The international governmental, commercial and

financial systems can simply no longer sustain or finance these subsidies through increases in ever-larger external debt too often supplied by the industrial nations' commercial banks. This reality must provide developing nations with the internal political justification for these admittedly domestically unpopular actions. The alternative is to become a non-player and face the political consequences of that action.

Government Intervention/Industrial Policy

Let me touch on one last issue for your consideration as you decide the best policies for the future of your case study country. The need to adjust to new domestic and international economic difficulties rests with both LDCs ad industrial nations. If we are insisting the LDCs adjust, then we must do so as well. This means adjustment not only to higher oil prices, but also to increasing competition from the advanced developing countries in our markets, even aside from the present debt situation, and to current problems of industrial overcapacity in our basic industries. Bluntly put, can any nation fail to adjust when it is losing comparative advantage to another section of the world in a particular industry?

The European Community has done well at conserving energy, but has also done perhaps the least of the OECD nations in terms of adjustment to the indirect effects of the oil price shocks and over-expansionary monetary policies. The EC has barely begun to reduce overcapacity and to accept the loss of comparative advantage to the Japanese and LDCs of the world. The result is reflected in part in their weaker exchange rates vis-a-vis the U.S. dollar.

Very weak economic growth and soaring unemployment have made adjustment both politically and economically difficult. Although some steps have been taken to encourage the retraining of workers and the reduction of overcapacity, progress toward this objective has been very slow. In the interim, the EC's system of industrial subsidies, import restraints, and variable levies and export subsidies in the agricultural area have increased the burden of adjustment for other countries such as the United States, Brazil, and Japan. I am sure you are familiar with the steel and agricultural disputes which have recently plagued U.S.-EC bilateral relations, and I won't reiterate them here.

However, some observers here are now arguing that we should mimic the EC industrial policy model -- both to bring the EC, and others, to the negotiating table, and to protect our own national interests for the future. In short, we should cartelize the world at the governmental level. The so-called industrial policy debate will be an active issue on next year's political agenda, I am sure.

Industrial policy per se is subject to various definitions. Its ostensible purpose is to help facilitate economic change, either through broad economic policies affecting all industries or through specific measures aimed at particular industries that are either: (1) in decline, (2) injured by foreign competition, or (3) growth industries of the future which need a boost to get ahead. While these are noble sounding objectives, in most forms industrial policy in fact offers a theoretical cover for protectionism, whether based on infant industry arguments or on the need to match what foreign countries are doing.

Key questions for industrial policy proponents to answer are:

(a) Who should be helped? Nascent industries or declining ones?

(b) How should they be helped? Through general tax measures, targeted subsidies, or trade measures?

(c) When, and for how long should assistance be given? By formula? How do you cut off help?

Is it conceivable that under our system of government, government economists and industry advisers can answer all of these questions properly, decide who, how, and when to intervene, and also get government out again when it's the right time? I know of no example of government policy that gives me optimism.

Has government assistance in the past helped industries to adjust? Have quotas, tariffs, or voluntary restraint agreements given industries the needed time to adjust? And have they used this time effectively -- or ended up by lobbying for more of the same? (Should we discuss the U.S. textiles, shoe, auto, or mushroom industries? Or perhaps specialty steel -- a modern well-managed segment of our steel inudstry that is still hurting today. Has government protection helped any of these?)

What do export subsidies do to the budget? Are they effective in increasing U.S. exports, or in matching foreign subsidies to avoid a decline in potential U.S. exports?

The most difficult issue is clearly when foreign governments' intervention adversely affects the U.S. ability to compete. What should our policy be? Do we counter foreign unfair practices, match them if our laws don't offer sufficient leverage to force a change in their practices, try to negotiate new international rules to define what kinds of intervention are fair? What are the effects of alternative approaches on the U.S. economy, world trade, and our own efforts to adjust?

These are not easy questions and I submit there are no simple or even theoretically pure answers. But I would caution that before mimicking European practices, the United States should look first at the relative success of those practices within the EC in fostering the needed long-term adjustment -- and then deci

Policy Options: A Case Study

At last, I come to the real policy options where you in the academic community may act as policymakers, but will need to consider the best alternatives in light of the current international economic situation.

You have the basic "facts" of the case before you. I've even given you some general policy considerations which I believe you should keep in mind -- although you are of course free to disregard any or all of my suggestions.

For purposes of constructing our case model, let's imagine that you are the Prime Minister of a mythical foreign industrial country in the current world situation. In your nation imports are increasing rapidly; unemployment is at a record level; your currency has appreciated relatively to your principle export markets currencies; protectionist pressures are growing on all fronts; exports are declining; the outlook for the trade deficit is staggering; LDCs are clamoring for better market access to pay off their ballooning debts; other countries are subsidizing exports, aggravating your export losses. You live in the world I have described.

Assuming a docile, obedient Parliament, no strong interest groups, no single-interest constituencies, and no need to compromise, what policies should you choose to espouse?

Assume you have to give a major TV address, focussing on the current economic situation. To prepare for the address -- and set the path for your future policies -- you have called a meeting of the Cabinet to ask for their advice. The Cabinet convenes. Your Ministers of Labor, Agriculture, Trade, Finance, Economics, and Foreign Affairs are all present. So is your personal economic counselor -- a trusted former economics professor from the University of Michigan, now retired. You have asked the counselor to join you to give his objective opinion on the economic effects of the advice of your Ministers. He has already won his Nobel Laureate and has no political aspirations in either the United States or your country. He sits at your side during the Cabinet debate.

Before you can even formally call the Cabinet meeting to order, your Labor Minister asks to speak. "Mister Prime Minister," he says excitedly, "we must, we absolutely must protect our own industries. These are our people who are unemployed, not foreigners. These people vote!"

"We have to increase domestic employment and production. We're losing jobs daily to the Japanese. Our unemployment rate is at an unacceptable level. The unions are threatening a general strike." Now waving his arms, he says, "our nation can help our people in several ways: through unilateral quotas, adjusted monthly according to consumption forecasts, or 'voluntary foreign export restraints' which our country would enforce."

"Also, existing restraints on imports from developing countries should be tightened and sensitive imports monitored for surges, especially that cheap specialty steel from Sweden and Germany. Advanced industrial countries should be graduated from special duty-free import preferences. And finally," says the Labor Minister, "bilateral aid should be tied exclusively to purchases of our exports. Oh yes, we do need new government subsidies to import-competing industries to help them to adjust into new products, introduce new capital equipment and retrain workers."

Your soft-spoken University of Michigan counselor calmly advises you that the costs of these measures would be increased consumer prices and substantial increase in inflation. Unless the domestic economy picks up, there will be few if any new jobs. "Economic adjustment of protected industries will be delayed" he says, "And with new import restraints on LDC goods, overall LDC balance of payments and debt situations will worsen, possibly causing a major global financial crisis and seriously affecting our banking system."

He cautions finally that your key political opponent is suggesting precisely this protectionist policy line to win labor support for the next election in two years. It will be very tough to get blue collar support if you insist on maintaining open markets, because the next opposition candidate for Prime Minister is expected to promise more domestic jobs by increasing protectionism. "Frankly, Mr. Prime Minister, unless you make a major effort to convince the public of the extreme dangers of such shortsighted measures, he may get the votes and all your policies will be reversed."

At this point, your Agriculture Minister breaks in and proposes export subsidies to increase agricultural exports and win back foreign markets. "Net farm income," he says "is now at its lowest point since the 1930s. We have huge government stocks, which cost the budget billions in outlays to maintain. Large quantities are spoiling in storage. And the outlook is for dramatic production increases next year."

"It is absolutely critical," he argues, "that our country dispose of heavy stocks which overhang the market in our products. And the Latin Americans are producing our crops and selling them in our overseas markets. I also think" says the Agriculture Minister, "that we should introduce a new system of variable import duties which will protect domestic prices from foreign competition."

You turn again to your special counselor. He says, "Sir, these agricultural measures will only increase exports if foreign countries don't match your export subsidies, an unlikely assumption given their situation. Or they may decide to use subsidies to take away your markets in other third country markets. But because agricultural goods are commodities that are totally fungible, it's questionable whether any substantial net new sales will take place at all. You may also find that your exports of non-agricultural goods to competing agricultural exporting countries, which your country depends on for substantial export earnings, may be cut off in retaliation. In addition," he says, "you may have to spend a lot of money, causing a major increase in your budget deficit and contributing to reinflation, higher interest rates, and foreign exchange movements. New variable import duties would isolate your market and raise consumer prices."

Your Trade Minister then leans forward, takes his pipe out of his mouth and says what more and more trade ministers are saying to him. "Mr. Prime Minister, we must try to negotiate new international rules to deal with the current problems. New rules could legitimize selective import restraints where there are rapid surges in imports due to currency appreciation. Because you have little negotiating leverage -- with our own market being pretty open -- you should bring others to the negotiating table by matching foreign export subsidies and countering unfair trade practices at the border."

The Trade Minister continues on with a plea for measures identical to foreign import barriers affecting your major exports, but designed to hit foreign countries on goods where it will hurt. It is his usual "get tough" reciprocity approach. "Domestically," he argues, "you should embark on a new path of industrial policies to boost the growth of key industries and maintain employment. And you really should ease monetary policy to reduce interest rates, which in turn will reduce the value of our currency. This would be supplemented by intervening in the markets to drive the currency down. I'm sure the Japaneese do it to the yen. We need a weak currency so we can export."

At this point, the Trade Minister, who always wants to reach a political consensus with the Parliament interjects, "Mr. Prime Minister, we must reach a consensus agreement to divide the world's markets into quotas for everyone. It's the only modern way. Otherwise, the more efficient producers will be the only ones to survive, and our most costly companies will either have to be nationalized or further subsidized. Frankly, I think it's time we recognized that these economic decisions are far too important to be decided on the basis of the supply, quality, and price of goods. Only politicians can make international economic decisions. These decisions are far too important to be left to the citizens, political officials understand what's best for them."

At this point, you turn to the counselor. Throughout the room icy stares are being directed at him. But you call on him again. "These approaches" he says, "could dramatically cut imports, but will increase domestic prices to everyone, delay adjustment, and cause a substantial budget deficit increase. Not to mention the probability that foreign nations would likely retaliate in kind, setting off a protectionist spiral, rather than serious negotiations. Trade wars triggered the great depression worldwide. Your Administration would become increasingly involved in business decisions, and tempers will rise as industries line up for assistance, claiming they all can be competitive with government help. Exports may temporarily increase once the value of the currency declines (with a 1-1/2 - year time lag), but essential imports such as oil will become more costly, aggravating the trade deficit in the short term.

More importantly, LDCs will suffer severely from loss of markets, and probably be forced to default on debts owed to the English banks where our own banks are so closely tied in the London market. It could precipitate a domestic financial crisis here if people lose confidence in our banks because of the U.K. situation. We would then lose deposit funds from our banks as people sought safety in gold or United States Treasury Bills or U.S. bank CDs or real estate. This would drive down our currency against the U.S. dollar, increase our cost of oil more than our exports, and dry out the liquidity in our banks that need funds to level out now. If our people and multinational corporations did withdraw these funds, we would face a capital flight crisis and some of our banks could collapse setting off a real depression here -- at a minimum, there would be no increase in domestic lending to our companies."

Now it is the Finance Minister's turn. He argues a free trade approach; maintaining as open a market as possible, and demanding compensation (in the form of better market access for other goods) from countries that impose import restraints. He turns to you directly and says, "Mr. Prime Minister, it is time that we ask for a strong pledge by all major countries to avoid protectionism. I am strongly opposed to any "quick-fixes" in either trade or short-term monetary policies. They don't work. We must emphasize the need for long-term domestic and international adjustment to market forces. Minimally inflationary economic policies should be maintained."

To help exports, the Finance Minister proposes credit guarantees rather than cash subsidies, but urges that there should be less conditionality in international borrowing from the IMF to assist LDC growth.

You turn once again to your economic counselor. Recognizing that at this point he is not about to win any popularity contests, the advisor decides just to keep being forthright and honest. He notes that there could be very costly political repercussions from this course. "Economic improvement will occur only gradually," he says. "Imports will continue to increase rapidly; the trade deficit will rise astronomically; interim unemployment will worsen until global growth -- including LDC growth -- picks up. Other countries may not live up to the anti-protectionism pledge if it has no teeth, worsening prospects for your exports."

Your Economic Minister now decides to put his oar in. "What we really need," he says, "is a change in the domestic policy mix. We ought to ease monetary policy to reduce interest rates and increase liquidity; cut government expenditures; reduce the budget deficit." He goes on to recommend a general tax strategy which will ease the adjustment burdens for domestic industries and stimulate investment and growth. "Mr. Prime Minister," he says, "you should keep your markets open to help lead the world into economic recovery, recognizing the importance of our economy to other nations' trade. But let's tip the terms of trade in our favor."

Noting the political/economic difficulties caused when some countries pursue disinflationary policies while others are inflating, he argues for regular consultations of economic ministers to assure better economic policy coordination.

By this time, the Cabinet knows that after each statement you are going to turn to the man from Michigan. This time the old advisor quietly explains that -- under this scenario -- interest rates should decline; as should the value of your currency, giving a boost to exports after a lag, as initial J-curve increases import costs. Economic recovery will be hastened, with benefits for other countries. However, protectionist pressures and unemployment will remain strong in the interim. The economy may reinflate. International policy coordination is unlikely to result in major immediate policy changes and could run counter to national sovereignty if pursued strongly.

Finally, your Foreign Affairs Minister proposes a new major round of U.N. trade negotiations, trading a change in domestic economic policies (to help lead other countries out of recession) for trade access in foreign markets. "Concessions" in policies on both sides could be subject to consultations, aiming at mutual growth. If not feasible, bilateral agreements to maintain market shares or voluntary restraint arrangements could be sought to minimize conflicts in political relations.

He proposes major debt reschedulings to assist LDCs, increases in bilateral foreign aid, and pressure on banks to maintain the growth of new loans to LDCs.

As the Foreign Minister finishes, heads turn again to your personal advisor. "Well," he says, "successful trade/economic negotiations could have the same beneficial longer-term growth effects as unilateral growth stimulus policies proposed by the Economic Minister. However, it is unlikely that economic and trade ministers would agree to this kind of "swap". Bilateral market share or "voluntary restraints" will have the same side effects as protectionist policies; increasing consumer prices and delaying of adjustment. Proposals to increase bilateral aid to help LDCs will increase your budget deficit, probably cause the central bank to increase the money supply and increase interest ratres. That will cause the currency to rise, which will hurt exports and increase unemployment in our export sensitive industries. And, last, if you're going to tell the banks who to lend to and how much, they are going to want the profits and ask the government to take any losses. That's like nationalization -- the government is on the hook."

At this point, you thank your economic counselor and the members of your Cabinet.

At the end of the meeting, your Ministers take a secret tally. They announce that they have reached a common recommendation for your action: you should fire your economic counselor. He obviously does not understand political realities.

Now you leave the room with your faithful speechwriter, Sir Flak, to prepare your TV address. What do you tell him to write?

* * *

I will not attempt to delve into the relative merits of each of the Cabinet Ministers' recommendations. However, let me leave you with a few general observations that will belie my policy bias -- if it is not already clear to you.

Virtually every country faces, to varying degrees, this kind of internal policy debate. And it is usually, if not always, the case that short run gains and long-term gains seldom run on the same track. One is usually faced with choosing one over the other.

Second, the long-term value of a course of action is often inversely proportional to its immediate popularity. And this brings me to the real issue here. Because what this case study is really all about is leadership: courageous, political leadership to take those actions which will redound to the maximum long-term benefit of one's country.

Making those hard decisions, and sticking with them, is not easy here in the United States or in any other country. But if individual economies -- and therefore the international system as a whole -- are to continue to progress, the hard, tough political decisions simply must be made.

Many of the current trade issues are closely linked to broader macroeconomic problems: slow domestic growth, high unemployment, and the strong appreciation of the dollar in the past two years, which is now being reflected in increased U.S. imports and declining U.S. exports.

The Administration is very sensitive to these problems and to the difficulties they are causing for workers and industries in many sectors. We know that the auto industry is now experiencing 20 percent unemployment and that capacity utilization has dropped to 60-65 percent. Similarly, for the steel industry, capacity utilization for 1982 to date is estimated at 50 percent, losses are projected to exceed $3 billion, and 40 percent of the workforce is on layoff or working short weeks.

These are sobering statistics. But we can't promise any quick-fixes that bring immediate relief. We have reached an agreement with the European Community on steel which should help deal with the problems of injury due to dumped or subsidized imports. And we will be discussing the issue of Japanese auto restraints for the third year of its restraint program in the months ahead. We have not been purist. We have tried to be pragmatic.

But the trade measures we have taken for these industries do not offer a panacea. They do not address the fundamental need to adjust to increasing global competition, to improve U.S. productivity, and to meet the challenge of new technologies. The increasing use of plastic instead of steel in the auto industry will have a profound affect on the steel industry in the future; its impact is already felt. Similarly, automation and the increasing use of robotics in automobile production will ultimately mean fewer workers per car produced -- and these workers need to be able to find employment somewhere else.

The U.S. Government will be vigorous in defending U.S. industries against unfair foreign trade practices. But this doesn't mean there will be no pain. The U.S., just like any LDC or other nation, cannot escape the need to adjust. The EC must recognize that it may be on the very verge of choosing a protectionist path that will result in its long-term industrial decay rather than recovery. Today there can be no long-term economic future alone. Those who argue for short-term self-serving protectionist policies have neither read history nor fully understood today's integrated world. Loss of comparative advantage is politically painful, but domestic political actions can't restore an international comparative advantage without costs and reactions. And, the actions can have adverse effects on other domestic groups through increased inflation.

We have to face these facts. We also have to recognize the fact that the United States will lead the global economic recovery, and that next year other nations will grow more slowly than the U.S. -- resulting in slower growth in U.S. exports than in U.S. imports.

This will be compounded by the short-term adjustment of LDCs to their current debt problems. New credits will be provided. Reschedulings will take place.

The U.S. trade deficit will grow substantially: from about $40 billion in 1982 to perhaps $75 billion in 1983. The current account will also sharply deteriorate. We can't unilaterally change this -- even the U.S. is influenced by other nations' actions.

I began this lecture with a broad analysis of what happened in the international economy during the 1970s and the early part of this decade. I then moved to the rather parochial policy decisions of a mythical country. Why? What links the two? Most people think that international economic policy comes as the result of international meetings -- that the upcoming GATT Ministerial, for example, can alone set the framework for trade relations.

I would contend that international economic policy is actually something quite different: it is the aggregate of all the separate decisions -- whether labeled international or domestic policy -- taken in individual countries that taken together determine the future of the international economy.

The trade ministers of the GATT countries may meet in Geneva and all pledge to avoid trade protectionism. But if they then go home and impose import restrictions or agree to voluntary restraint arrangements or subsidize exports because of political pressures, what happened in Geneva will not really matter at all.

The United States must take the lead in opposing further protective measures in response to domestic trends. We must provide the momentum toward further liberalizing of the world's trading system. Our own economic growth and future prosperity -- and that of other nations with which is integrally related -- is too important to risk setting off a trade war, and imperiling global economic recovery in the process.

If we are to continue to be the political and economic leader of the Free World we must eschew the easy political choices and demand the hard economic adjustment -- of ourselves, of the OECD countries, and the G-77. It is our obligation. Indeed it is a test, because the poor and hungry of the world look to the United States for future hope and for help in economic development. We will not turn our back on the LDCs regardless of the posture of our Japanese or EC partners take in Geneva.

The United States will exercise the responsibility of leadership, not abdicate it to short-term political opportunitism. And, we call on all who seek economic prosperity to join us in preserving, enhancing, and accelerating the inexorable linkage of the world's integrated trade and financial system.